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China's Economy in 1994 and 1995: Overheating Pressures Recede, Tough Choices Remain

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Summary

Information available as of 15 November 1995 was used in this report.

Central leaders over the past two years have succeeded in dampening inflation and other unwelcome side effects of China's dramatic economic expansion:

- Gross Domestic Product (GDP) increased by 11.8 percent in 1994, still one of the fastest growth rates of any major economy but down by nearly 2 percentage points as compared with 1992 and 1993. GDP growth slowed further in the first three quarters of 1995 to 9.8 percent as compared with the same period in 1994.

- Beijing's restrictions on credit and approvals for new projects helped reduce the growth in nominal spending on fixed assets—a key driver in the economic expansion and also a culprit in economic overheating—to 27.8 percent in 1994, or less than half the nominal growth rate in 1993.

- Spurred by food price hikes, inflation remained stubbornly high as consumer prices increased by 25.5 percent in 1994, second only to 1988's inflation. By the fall of 1994 food price hikes began to ease, however, and central authorities helped to reinforce price stability with a 10-point anti-inflation agenda announced by Premier Li Peng in September. By September 1995 the consumer price index was up by only 13.2 percent as compared with September 1994.

- Foreign trade helped to boost growth as exports surged by 31.9 percent to $121 billion in 1994, in part because foreign exchange reforms and changes in the tax system increased incentives to export. China's imports grew by 11.3 percent in 1994—as compared with nearly 30 percent in 1993—to $115.7 billion, resulting in a $5.3 billion foreign trade surplus in 1994.

Central leaders in 1994 and 1995 also continued to implement some elements of the reform agenda that had been approved by the November 1993 Central Committee plenum, including fiscal and financial reforms designed to improve the central government's powers to regulate the economy:

- Central authorities made progress through 1994 in ironing out problems with the new taxation system introduced in January and in establishing central tax offices in most provinces.

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- Reforms in the banking sector included the formation of three new policy lending banks, which are slated to take over policy-directed loans to support agriculture and to assist key state industries. The regime also promulgated a central bank law and a commercial bank law in the spring of 1995.

- Foreign exchange system reforms introduced in January 1994 that unified the official and "swap center" rates resulted in a depreciation of the Chinese currency for official transactions and contributed to the rise in official foreign currency holdings to more than $51 billion by the end of 1994—the world's fifth-largest reserve of hard currency.

Leadership concerns over labor disturbances, however, have tempered progress on other key reforms. Chinese media in late 1994 began touting the state-owned enterprise sector as the focus of structural reforms in 1995, for example, but authorities have moved gingerly with potentially disruptive steps, such as bankruptcy and privatization. Experiments with commodities and treasury bond futures markets also slowed in the face of Beijing's concerns over price fluctuations and corruption. Beijing's response to these problems—including shutting down trading in treasury bond futures in May 1995—underscores the leadership's current focus on better preparation and supervision over reforms rather than on bold new breakthroughs.

Although inflation and other signs of economic overheating have receded, Chinese leaders continue to face tough policy choices in regulating the economy. Indeed, as inflation indexes fall, there are increasing demands on central leaders to ease credit and investment controls to help struggling state enterprises and to boost regional growth rates. Central leaders must balance the risk that easing these controls could fuel new price hikes against the prospect that continued anti-inflation policies could trigger labor disturbances if more enterprises fail to meet payrolls while new job opportunities shrink.

Central leaders must also continue to balance the costs and benefits of tough reform steps. Beijing remains committed to the reform agenda approved two years ago, and Chinese media reports claim that reform steps in 1996 will include passage of further economic legislation and the strengthening of such economic institutions as the central bank. However, the regime's reluctance to press ahead with tough reform steps such as bankruptcies among deficit-ridden state enterprises is increasing the burden of state-sector debts on the state banking system and is therefore hindering financial sector reforms. Central leaders also face obstacles in completing other reforms initiated during the past two years. Although tax reforms have

begun to erect a new framework for collecting central revenues, for example, the regime must strive to extract and retain more taxes from localities to achieve key tax reform goals. Progress on these reforms in the near term may be further hampered by central leadership caution as China approaches the end of the Deng Xiaoping era.

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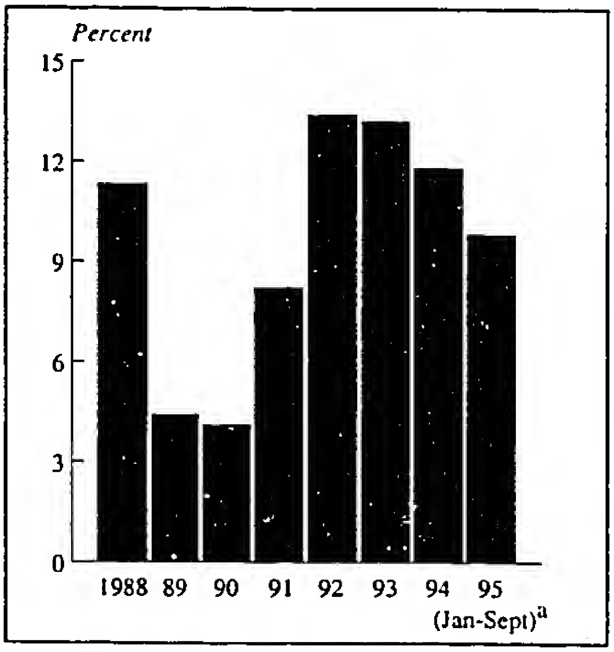
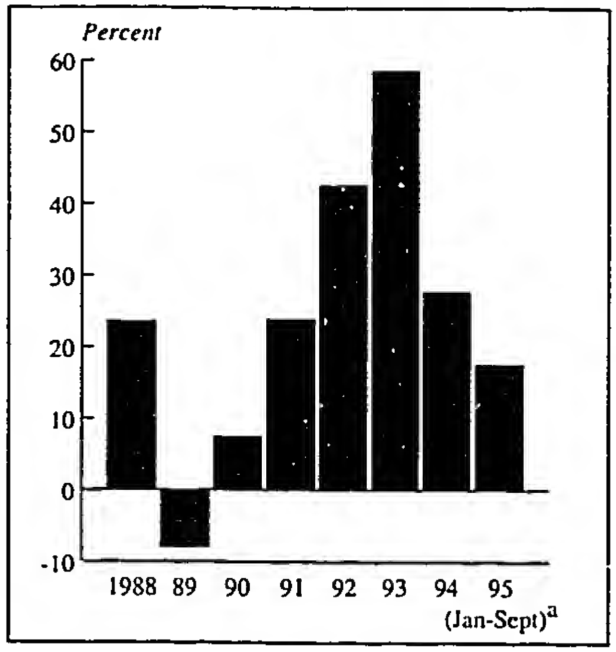
Figure 1
China's Growth Pressures Ease: Selected Key Indicators, 1988-95

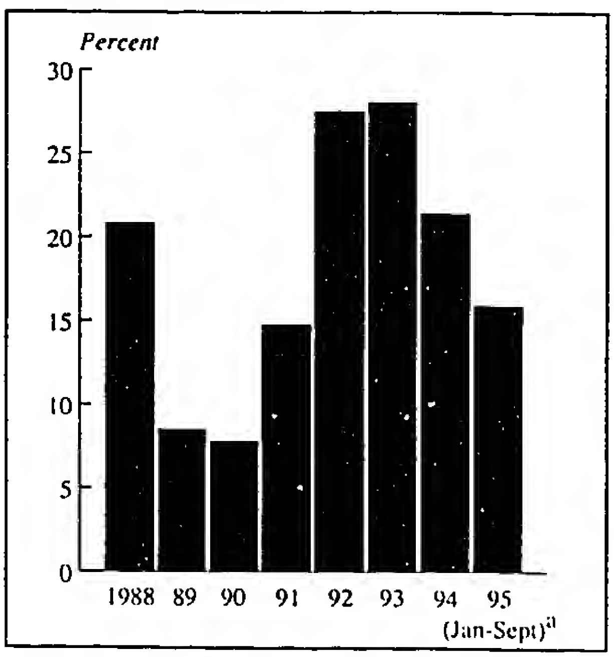
Real GDP Growth



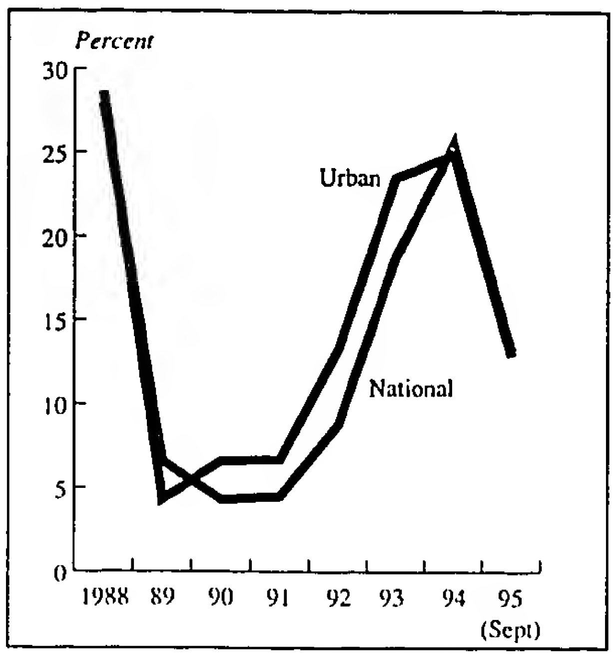
Nominal Growth in Investment in Fixed Assets



Industrial Output Growth[b]



Inflation[c]



[a]Compared with the same period in 1994.
[b]Gross value of industrial output (GVIO) calculated using constant prices.
[c]Consumer price indexes for December of each year compared with December of preceding year. Urban inflation is based on the consumer price index for workers and staff in 35 large cities.
Source: Official Chinese statistics.

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China's Economy in 1994 and 1995: Overheating Pressures Recede, Tough Choices Remain

Central Leaders Struggle To Control Inflation...
Chinese central leaders over the past year and a half have made progress in dampening inflation and other unwelcome side effects of the dramatic economic expansion spurred by Deng Xiaoping's early 1992 calls to speed development. While problems linked to economic overheating have receded, however, central leaders face tough choices in managing the costs of slowing growth while undertaking challenging and risky economic reforms.

The regime's economic policies in 1994 and early 1995 continued to be dominated by the search for a so-called soft landing under which the economy would gradually slow without suffering the kind of slump that followed expansionary cycles in the 1980s. To achieve this goal, central leaders employed elements of the "16 points" inaugurated by Vice Premier Zhu Rongji in July 1993, including moderate credit restraints and caps on new investment spending. These policies helped to slow the growth in nominal spending in fixed assets to 27.8 percent in 1994—less than half 1993's nominal growth rate of 58.6 percent—helping in turn to ease shortages and even reduce prices of some construction materials such as steel and cement.[1] Central leaders also continued to crack down on unauthorized lending and to limit speculative activities they blamed for at least some economic overheating pressures. Authorities combined these administrative controls with some market-based measures, including the introduction in March 1994 of inflation-indexed interest subsidies for three-year and longer time savings deposits and government bonds to encourage savings.

While the economy remains generally robust, these policies have succeeded in reducing growth to single-digit levels for the first time since late 1991. GDP increased by 11.8 percent in 1994, still one of the fastest growth rates of any major economy but down by nearly 2 percentage points as compared with 1992 and 1993. Growth slowed further in the first three quarters of 1995 as GDP increased by 9.8 percent compared with the same period in 1994.

[1] Recent Chinese official statistics revised investment spending and growth rates for 1992 and 1993 upwards.

Foreign trade was a major source of growth in 1994 as exports surged by 31.9 percent to $121 billion, in part because foreign exchange reforms and changes in the tax system increased exporting incentives. In addition, foreign investment in recent years has added to exporting capacity; paid-in foreign investment increased by 31 percent to $33.77 billion in 1994, partially offsetting declining growth rates of domestic investment. China's imports grew by 11.3 percent in 1994—as compared with nearly 30 percent growth in 1993—to $115.7 billion. The slowdown in import growth reflected reduced demand for some commodities as well as government-mandated restrictions over some types of imports, including crude oil. Beijing's policies helped China achieve a $5.3 billion foreign trade surplus in 1994—and a $16.4 billion surplus in the first nine months of 1995—reversing the $12.2 billion trade deficit of 1993 when imports soared in response to booming domestic demand.

Although most indicators showed economic overheating pressures easing through 1994, progress in reducing inflation—the leadership's key "soft landing" policy goal—became apparent only in the final months of the year. Indeed, central leaders missed their inflation target of less than 10 percent for 1994 by a wide margin as the year-on-year consumer price index for December—which we also use for 1994's annual inflation rate—stood at 25.5 percent, second only to 1988's inflation:[2]

- Price levels continued to rise through much of 1994 in part because the regime sporadically relaxed

[2] China also publishes annual inflation figures that are lower than the December-over-December index for years when price increases are accelerating. The Chinese annual inflation index for 1994 was 21.4 percent, 3 percentage points higher than 1988's annual inflation index.

Beijing Focuses on Statistical Shortcomings

Except where indicated, this report draws on figures and statements from Chinese statistical bulletins, government work reports, and articles in the official press to track economic performance. In general these statistics and reports provide useful measures that correlate with observable trends in China's economy. Furthermore, China continues to expand its statistical coverage. Newly released figures on the banking sector, for example, provide a fuller statistical portrait of the financial sector and monetary aggregates. Nevertheless, Chinese statistics need to be used with care; Chinese officials themselves have recently highlighted shortcomings in the nation's statistical reporting.

In some cases the introduction of improved measures complicates comparisons with past statistics based on old standards. Statistical authorities, for example, have substantially increased official tallies of the output of the nation's service industries—in early 1995 they boosted their estimates of the output of service industries in 1993 by roughly one-third—and have based total GDP figures for recent years on these larger service-sector contributions. The GDP growth rates for 1994 and 1995 cited in this report are based on these new figures, but authorities have not yet recalculated growth rates for earlier years according to the new service-sector estimates. We have used footnotes throughout this report to highlight other recent revisions in statistical yardsticks.

As part of efforts to improve the accuracy of statistics, Beijing launched an investigation in early 1994 that uncovered some 20,000 cases of localities submitting false or misleading statistics, according to Chinese press reports, including erroneous figures for rural birth rates, local per capita income levels, grain output, and inflation. The problem most commonly cited in the press accounts is overstating output figures for rural industries. The investigations, for example, revealed that many rural firms report production figures to statistical collectors at current rather than at 1990 constant prices, in part because enterprise accountants lack the resources and training to make the price conversions. As inflation drives prices up, firms that report output using current prices introduce an upward bias in output statistics for the entire sector. The investigation also uncovered deliberate cases of falsifying statistics, including claims that rural firms were operating at maximum capacity even though production had in fact stopped, according to Chinese press reports.

Inflated rural industrial output statistics can contribute to a misleading picture of the structure of China's industry and may also inflate GDP gains. Although the magnitude of the error is not enough to threaten China's stature as one of the world's fastest growing major economies, such flawed statistics may lead authorities to misjudge the need for macroeconomic adjustments to either rein in or stimulate the economy.

lending and other controls in response to signs of distress from cash-strapped state enterprises. Chinese press reports indicated, for example, that banks issued a large amount of short-term loans in the second quarter of 1994 to stimulate output from state industries. The lack of tighter fiscal constraints in turn helped many firms to boost wages faster than warranted by productivity gains—total wage payments increased by one-third in 1994—thereby shielding many urban residents from the impact of higher prices but also fueling inflationary pressures.

- China's strong foreign trade and investment performance—which helped push foreign exchange holdings up 166 percent in 1994 to more than $51 billion—also carried an inflation penalty. Beijing still lacks effective mechanisms, such as open-market operations, for offsetting the rise in the domestic

money supply that occurs when the central bank buys foreign exchange. The jump in foreign exchange reserves therefore contributed to a 34.4-percent increase in the broad money supply (M2) in 1994, the highest annual growth rate in recent years.

- In a move that hit consumer pocketbooks, the regime raised official grain procurement and selling prices by roughly 40 percent in June 1994 to help boost the sagging rural economy and stimulate grain output. Hoarding and local shortfalls compounded the effect of these mandated price adjustments—grain prices in markets actually began rising in late 1993 as farmers and traders anticipated higher state-set prices—and by early 1995 grain prices nationally were roughly 50 percent above prices a year earlier.

With price indexes continuing to rise, central authorities reinforced their anti-inflation efforts with a 10-point agenda announced by Premier Li Peng in September 1994. The 10-point agenda reiterated key elements of the mid-1993 "16 points" by combining price controls with restraints on new investment spending. The new agenda, however, also focused on heading off further food price hikes by stepping up pressure on localities to produce grain, by boosting grain imports, and by limiting exports of corn and rice to help alleviate local shortages. These policies helped stabilize food prices at a time when the impact of the sharp price hikes of the previous autumn on 12-month inflation indexes began to recede. The consumer price index hit its peak in October 1994 of nearly 28 percent as compared with October 1993, and then began falling steadily. By September 1995 the index dropped to 13.2 percent, the lowest rate since April of 1993.

...While Balancing Reform Gains and Risks

As they struggled to cool the overheated economy, central leaders in 1994 and 1995 also pressed ahead with elements of the reform agenda that had been approved by the Central Committee plenum in November 1993. In particular, the leadership supported fiscal and financial reforms designed to improve the central government's powers to regulate the economy:

- Central authorities made progress through 1994 in ironing out problems with the new taxation system introduced in January—forms to document payments of value-added taxes, for example, were initially unavailable in some localities—and in establishing central tax offices in most provinces. Despite the uncertainties of the new tax system, Beijing held the 1994 deficit to its budgeted target. Other objectives of the tax reform effort—including boosting overall revenue collections as a share of GDP and equalizing tax rates among firms regardless of ownership type—have yet to be realized.

- Reforms in the banking sector included the formation of three new policy lending banks that are slated to take over low-interest policy loans to support agriculture and to assist key state industries. Chinese legislators also approved a central bank law and a commercial bank law in the spring of 1995. Financial officials claimed that the commercial bank law would help banks resist arm-twisting by government officials to provide loans to pet projects, while the central bank law would boost the independence of the People's Bank of China in setting monetary policy.

- Central leaders have also touted the success of foreign exchange system reform introduced in January 1994 that unified the official and "swap center" rates. The unification resulted in a depreciation of the Chinese currency for official transactions and contributed to the rise in official foreign currency holdings to more than $51 billion at yearend—the world's fifth-largest reserve of hard currency.

The leadership also focused on reforms to establish a "modern enterprise system" as better accounting methods revealed the extent of losses at state-owned enterprises. The Chinese media in late 1994 described the state-owned enterprise sector as the key focus of structural reforms in 1995 and spotlighted programs to convert 100 state firms to limited liability or joint stock companies and to implement less comprehensive ownership reforms at thousands of other firms.

New Economic Laws Strengthen Reforms' Legal Foundation

Beijing over the past two years has stepped up the introduction of new legislation to complement economic reforms. Although the major laws listed below represent progress in establishing a legal foundation for emerging competitive markets and economic institutions, they generally deal with broad principles and objectives rather than provide detailed regulations for adjudicating disputes and handling infractions:

- *The budget law adopted by the National People's Congress (NPC) in March 1994 defines the powers of central and local authorities in drawing up and implementing government budgets. Stipulations in the law restrict local jurisdictions from issuing bonds to cover deficits, using revenues for unauthorized purposes, or concealing revenues from central authorities.*

- *The foreign trade law adopted by the NPC in May 1994 provides the basic statutory framework for the current trading system. The law allows for the granting of national treatment for trade in both goods and services to contracting parties of international agreements that China joins. The law also allows the government to restrict trade to protect domestic industries.*

- *The company law, which became effective in July 1994, clarifies the terms under which enterprises—including those owned by the state—can become limited liability or shareholding companies. Firms that meet specific conditions can issue shares to help clarify ownership rights among government units, other enterprises, and private and foreign investors.*

- *The labor law approved by the NPC Standing Committee in July 1994 stipulates that workers must have employment contracts that are subject to collective bargaining—although China does not permit independent labor unions to act as worker representatives—and directs localities to establish boards for arbitrating labor disputes.*

- *The central bank law passed by the NPC in March 1995 states that the People's Bank of China is responsible for conducting monetary policy to stabilize the currency and to promote economic growth. In a step that strengthens the central bank's independence, the law stipulates that the central government can no longer force the bank to honor overdrafts to cover a portion of the central government's budget deficit.*

- *The commercial bank law, which became effective July 1995, provides a framework for developing a competitive banking industry comprising the major state-owned banks and a growing number of smaller commercial banks and foreign bank branches. The law defines the legal powers and obligations of commercial banks, allows the central bank to take over a commercial bank in a "state of credit crisis" to protect depositors' interests, and includes measures designed to eliminate interference by local governments in bank lending policy.*

- *The insurance law passed by the NPC Standing Committee in July 1995 likewise provides a regulatory framework for the emerging competitive insurance industry as the monopoly of the state-owned People's Insurance Company of China erodes. The law includes provisions for establishing and operating insurance firms and places the regulation of the insurance industry in the hands of departments within the People's Bank of China. The law for the first time separates commercial and property insurance from life insurance.*

Ever-present leadership concerns that rapid state-sector layoffs could trigger labor disturbances, however, have slowed implementation of key elements of the state-sector reform drive. Although the regime in late 1994 highlighted plans to bankrupt selected state-owned firms in 18 cities to test bankruptcy procedures, for example, authorities moved gingerly with outright closures. And, despite the conversion of some state firms to joint shareholding companies or other mixed ownership forms, regime spokesmen reiterated that China would not permit wide-scale privatization as a solution for state-owned enterprise problems.

Other market-oriented experiments also slowed in the face of Beijing's concerns over price fluctuations and corruption. Beijing cracked down on commodities futures markets in mid-1994, for example, to help control prices and to stem losses that some state-sponsored traders had incurred, and in May 1995 the regime suspended all trading in government bond futures indefinitely following a series of scandals on Shanghai's securities exchange. The regime subsequently authorized some commodities futures markets to conduct business and has signaled that work continues on legislation and other steps that could enable securities markets to function with fewer abuses. Beijing's response to these problems, however, underscores the leadership's current emphasis on better preparation and supervision over reforms rather than on bold new breakthroughs.

Indeed, the central leadership's three leading policy priorities for 1995 for the most part focused on resolving immediate economic problems while fine-tuning existing reform initiatives. Fighting inflation remained a key goal; even though price inflation showed signs of easing through early 1995, Chinese press accounts continued to call for "arduous efforts" to achieve the 1995 target of reducing the annual inflation index to 15 percent.[3] Central leaders also highlighted measures to shore up two troubled economic sectors. As noted above, concerns over deteriorating state enterprise performance spurred a series of centrally supervised initiatives, leading some Chinese press reports to dub 1995 "the year of enterprise reform." Central leaders also called for more assistance to agriculture in 1995 to ensure a good harvest and thereby help forestall further food price hikes. All three policy priorities in fact reiterated longstanding leadership pledges to tackle China's toughest economic problems.

China's Economic Sectors in 1994 and 1995

Food Price Hikes Spotlight Rural Issues. Sharp increases in grain prices in 1994 focused renewed central leadership attention on the rural sector even though the output of major agricultural commodities in fact remained relatively stable or even posted some gains. At 444.6 million metric tons, China's 1994 grain harvest was the third largest on record and was down only 2.6 percent as compared with 1993. Although cotton production remained well below the 1991 record, the 1994 harvest increased by 13 percent over 1993 to 4.26 million tons, and China set a record in 1994 for production of edible oils.

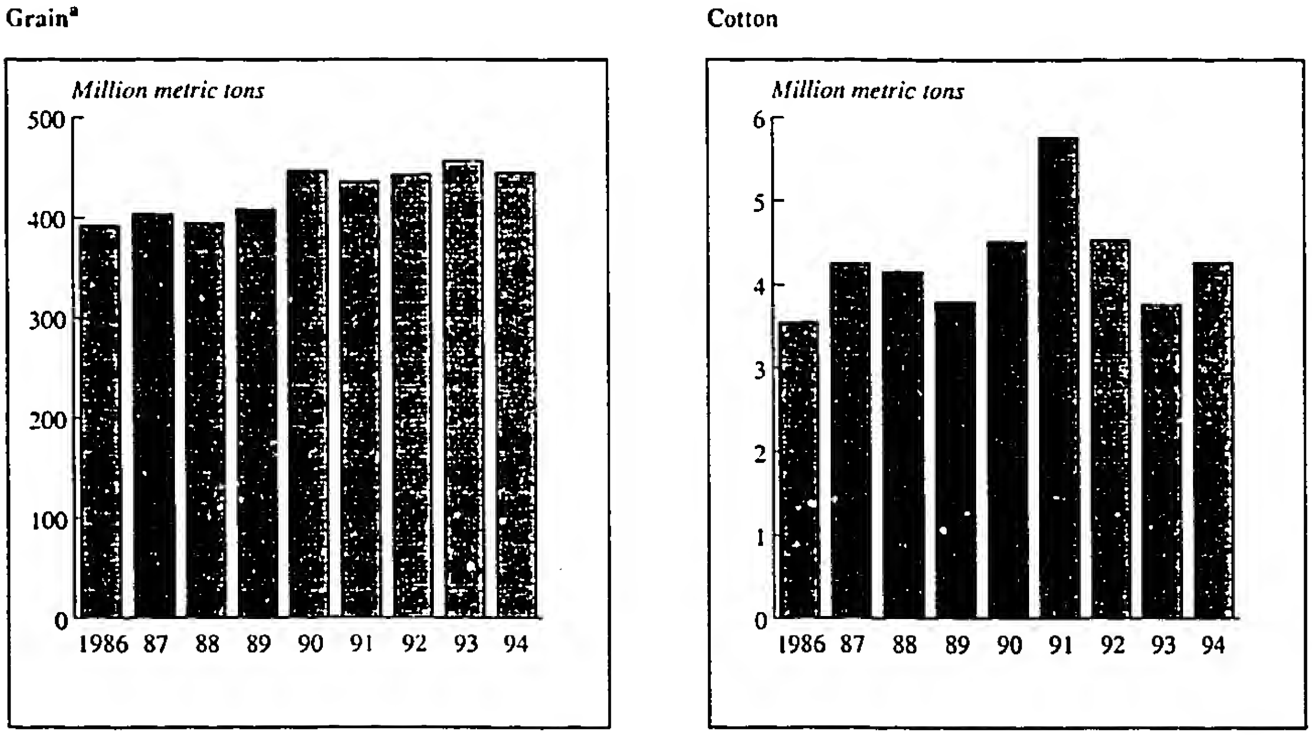
While the decline in grain output was modest nationally, shortfalls in areas that suffered from droughts or floods were more severe. Problems in addressing these local shortfalls—and other factors that contributed to price hikes—highlighted the difficulties of managing a complex economic sector where market-based allocation and distribution systems are still developing. Authorities may have had trouble in quickly shifting grain from surplus areas to deficit regions, for example, because of transportation bottlenecks compounded by sluggishness in the bureaucratic system that manages state grain reserves.

Regime concerns for the rural sector were fueled by other disturbing trends:

- Central authorities fretted about the destruction of cropland as localities pressed ahead with industrial, housing, and infrastructure development projects—schemes that can earn far more profit for local officials than grain cultivation. Although annual losses

[3] The 15-percent inflation target is based on the annual inflation index rather than the December-over-December index we cite in this report.

Figure 2
China: Grain and Cotton Production



[a]Grains include wheat, rice, corn, soybeans, and potatoes.
Source: Official Chinese statistics.

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amounted to less than 1 percent of total cultivated acreage, in 1994 the area devoted to grain production fell below Beijing's self-declared "warning line" of 110 million hectares.[4]

- Income disparities between rural and urban residents also continued to widen. Although state-mandated grain price hikes in mid-1994 helped the regime achieve its goal of boosting real rural per capita incomes by 5 percent, this growth still lagged behind the nearly 9-percent per capita income growth scored in urban areas.

To avert further food price hikes, Beijing, beginning in late 1994, focused on the need to ensure a bumper harvest in 1995. The regime made provincial governors responsible for protecting cropland and for taking other steps to promote grain production in their areas. Meanwhile, the central government adjusted its grain trade policies by boosting imports and restricting exports of corn and rice, steps that have sharply reversed China's recent performance as a net grain exporter. Authorities also pledged to boost bank lending to agriculture by 26 percent and to increase state

[4] Beijing in 1994 revised the official figure for total cultivated acreage upward by as much as 30 percent to roughly 120 million hectares.

budget allocations to support agriculture by at least 10 percent in 1995.

To bolster the regime's ability to enforce price controls on basic foods, the regime in early 1995 enhanced the role of government-controlled units in marketing grain to urban consumers:

- By early 1995 several dozen major cities had reintroduced grain ration coupons—rationing had been virtually eliminated by early 1993—to enable low-income urban residents to purchase grain at below-market, subsidized prices.

- The Ministry of Internal Trade signaled in early 1995 that it intended to increase the proportion of basic foods marketed through state rather than private channels, and authorities in some major cities began converting some individually and collectively run grain shops to state control, according to Chinese press accounts.

Regime policies to boost grain output in 1995 appear to have reversed the modest production slump of 1994; officials are forecasting that the annual grain harvest will probably reach 455 million tons, which would nearly equal the 1993 record. Nevertheless, this would still only be a 2-percent increase over the 1990 harvest—a growth rate that has failed to keep pace with rising demand for grain.

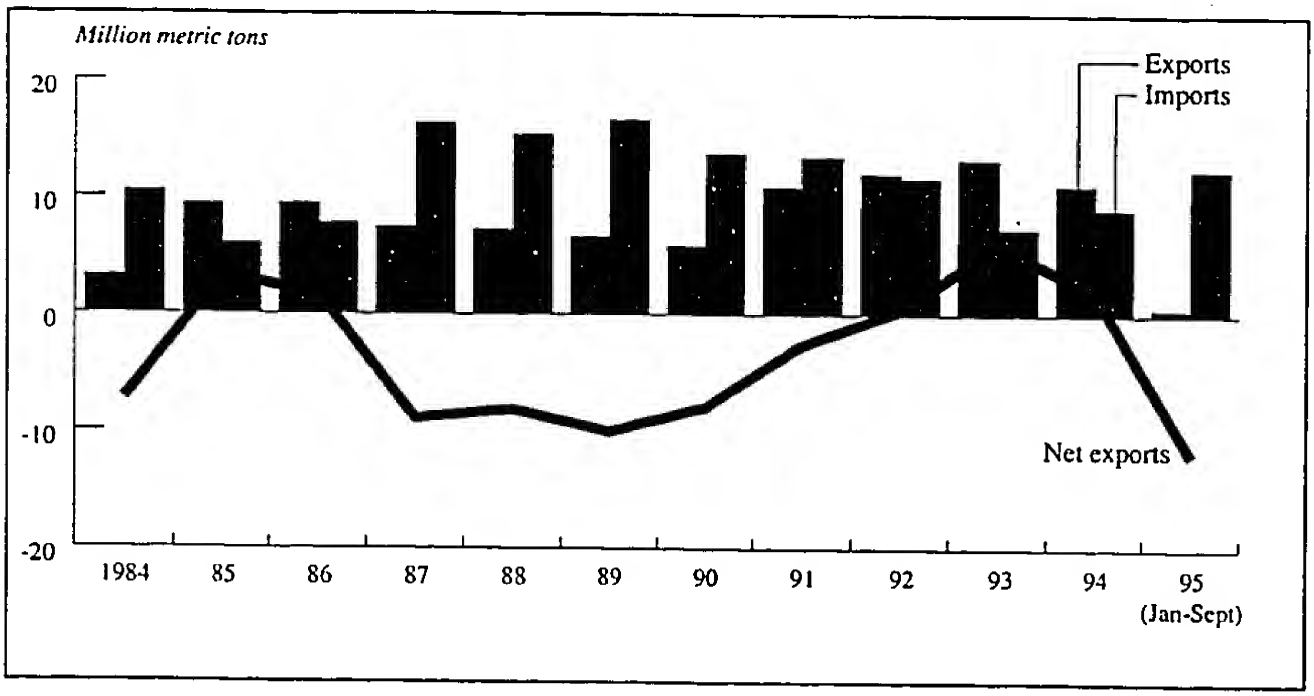
In response, central leaders have reemphasized their target of harvesting between 490 and 500 million tons of grain by the turn of the century to limit China's dependence on foreign suppliers as domestic grain demand continues to grow. Although only a 10- to 12-percent increase from 1994 levels, the grain production target will have to be met at a time when industrial and urban development will almost certainly continue to reduce the land available for grain cultivation. To accomplish their goal Chinese authorities recognize that more investment is needed to improve the use of agricultural technology, increase irrigation and storage facilities, reclaim and upgrade low-yielding acreage, and to introduce more effective marketing systems.

The regime, however, has difficulty fulfilling its pledges to boost investment in these kinds of desirable—but often low-profit—projects. Local officials, for example, often divert funds earmarked for basic agriculture into higher profit ventures, such as rural industries. Vice Premier Zhu Rongji told a national telephone conference in May 1995 that such diversions were widespread and hurt prospects for a bumper harvest. Furthermore, some of the gains in agricultural funding—investment in fixed assets devoted to agriculture increased by nearly 30 percent in the first half of 1995—have been eroded by inflation. Chinese press reports have indicated that investment in agriculture still amounted to only 1.6 percent of total national investment in fixed assets in the first half of 1995, up a bare one-tenth of one percent from the same period in 1994 despite the priority central leaders have placed on boosting funding to the sector.

Industrial-Sector Red Ink Spurs Reform Push. In reforming state-owned enterprises, Chinese leaders are wrestling with inefficiencies and imbalances in an industrial sector that continues to post substantial output gains. China's gross value of industrial output increased by 21.4 percent in real terms in 1994, down by roughly 7 percentage points as compared with the growth rates of 1992 and 1993 but still the third-highest growth rate since 1978.[5] The value-added output of China's industries—a statistical yardstick that reduces double counting of intermediate industrial goods in the final tallies as compared with the traditional gross output value measure—increased by 18 percent in real terms. Of the value-added increase, output from state-owned enterprises grew by only 5.5 percent, whereas that from collectively owned enterprises increased by 21.4 percent, and output from other types of firms—primarily Sino-foreign joint

[5] Beijing has revised gross value of industrial output (GVIO) growth rates for 1992 and 1993 upward in recent statistical reports.

Figure 3
China: Foreign Trade in Grain, 1984-95



Source: Official Chinese statistics.

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ventures, foreign-owned firms, and private enterprises—grew by 28 percent.[6]

Industrial statistics continued to reflect China's unbalanced structural growth as the production of consumer- and export-oriented products outpaced growth in many basic industries dominated by state ownership. Output of the crucial energy sector, for example, increased by only 4.7 percent in 1994—led by a 9.6-percent increase in electricity generation—contributing to persistent energy supply shortfalls. Coal production—the source of more than 75 percent of China's total energy—increased by roughly 5 percent to 1.21 billion metric tons. Production from China's onshore oilfields actually dropped slightly for

[6] Chinese officials point out that one reason for lagging growth among state-owned firms is the formation of joint ventures between state firms and foreign partners. Although the state generally remains majority owner in these enterprises, their output is excluded from the state-owned category in statistical tables. If output is apportioned on the basis of state holdings—thereby including a portion of production from state-foreign joint ventures—the value-added output for state-owned enterprises increased by 6.8 percent in 1994.

China's Renewed Reliance on Imported Grain

Beijing's efforts to boost domestic food supplies by cutting grain exports and increasing imports have made China a net grain importer in 1995 for the first time since 1991. Grain exports in the first nine months of 1995, for example, plummeted to only 520,000 metric tons as compared with nearly 9.6 million tons in the same period in 1994. Although the sudden drop in grain exports is exceptional—even in years when China has been a net importer of grain it has usually exported millions of tons from grain surplus regions—this is not the first time that uneven harvest results, rising domestic demand, and changes in government policy have shifted the pattern of China's grain trade:

- *After net imports peaked in the early 1980s—reaching 15 million tons in 1982—a series of bumper harvests through 1984 enabled China to become a net grain exporter in 1985 and 1986. As harvests leveled off, however, the grain trade balance moved to deficit again in 1987, and in 1989 net imports exceeded 10 million tons.*

- *China's grain trade shifted again following the 1990 bumper harvest. Although China remained a net importer in 1991, grain exports jumped by 86 percent to more than 10 million tons. Coupled with modest declines in imports, this export surge enabled China to again become a net grain exporter in 1992.*

Rising domestic demand and modest harvest gains since 1990 have eroded Beijing's ability to sustain these high export levels. But forecasts of China's ability to meet rising demand without relying more heavily on imports vary widely. Beijing remains committed to a policy of virtual grain self-sufficiency both to conserve foreign exchange and to avoid dependence on foreign suppliers for basic foods. Some Chinese and foreign economists argue, however, that China should shift to higher value crops and depend more heavily on imported grain to make best use of its limited arable land.

the first time since major fields began producing in the 1960s, according to preliminary statistics. Production from offshore oil wells offset the onshore decline; total crude oil production increased by less than 1 percent to 145.9 million tons. The drop in onshore production nevertheless underscored warnings that China needs to speed the development of new reserves to sustain output levels. China's net crude oil exports actually increased by 60 percent to 6.14 million tons in 1994 as compared with 1993—in part because the government banned all but a few major state oil companies from importing crude oil and refined products—but longer term trends point to China's growing dependence on imported oil.

Central authorities in June 1994 launched a new effort to restructure and consolidate key industries with the promulgation of the "Industrial Policy Framework" and the complementary industrial policy for the automotive industry—the first of several promised sector-specific documents for China's so-called pillar industries. Chinese press reports also suggest that Beijing intends to make energy and other infrastructure projects a priority under the Ninth Five-Year Plan (1996-2000) currently being drafted, while emphasizing "intensive" efforts to squeeze more and better quality output from existing factories instead of continuing to add new production capacity.

The government's policy priority in the industrial sector in 1994 and 1995, however, focused on renewed attempts to stem losses at tens of thousands of state-owned industrial enterprises. Improved statistical accounting measures had revealed in early 1994 that nearly one-half of state-owned industries—which still turn out over 40 percent of China's industrial output and employ about two-thirds of the industrial work force—were running at a loss. Although the proportion of state firms reporting red ink dropped during the year, the ratio climbed again to over 45 percent in early 1995. State-owned enterprise problems—including low-efficiency and outmoded, low-quality products—were aggravated by anti-inflation policies that restrained investment and credit expansion. By the end of 1994 stockpiles of unsold products—primarily

Beijing's New Industrial Policy Push

Chinese central authorities in June 1994 unveiled a long-term effort to rationalize and restructure key industries under a new industrial policy "framework" promulgated by the State Planning Commission. Shortly after announcing the framework, authorities released details of a supplemental industrial policy document for the automotive sector and indicated that policies for other selected key industries, such as telecommunications and chemicals, were being drafted.

Beijing's approach under this policy in general is to designate major enterprises or enterprise conglomerates as dominant players in each sector while encouraging the elimination or merging of redundant small-scale producers. This approach dovetails with plans to transform selected state enterprises into giant conglomerates that would overcome regional and departmental boundaries by drawing diverse firms together under an enterprise group umbrella. In the process, central authorities undoubtedly expect that the industrial policy strategy will overcome the inefficiencies of China's dispersed industrial structure—a remnant of Maoist demands that each locality construct a "small but complete" economy:

- *The automobile industrial policy, for example, designates a limited number of major state-owned auto producers with ties to the central Ministry of Machine Building Industry—along with their subsidiary joint ventures with foreign auto firms—as industry leaders. The policy cuts off other plants with an output capacity of less than 150,000 units a year from further investment in upgrading or expansion, thereby curtailing the ability of localities to expand the hundreds of automobile plants scattered throughout the country that each turn out only a few thousand vehicles a year.*

- *The industrial policy initiative also appears aimed at protecting key sectors from foreign competition by limiting access to imported goods and placing restrictions on foreign investment. The automotive policy, for example, calls for limiting imports of cars and places a temporary moratorium on approvals for foreign-funded auto plants. Once the moratorium is lifted, the policy stipulates that new foreign-funded auto plants must source at least 40 percent of the content of their vehicles from producers in China.*

at state firms—were valued at over 400 billion yuan. With funds tied up in such products or lost in unsuccessful relending schemes, unpaid debts between enterprises—again primarily among state firms—increased by 75 percent in the last half of 1994 to 631 billion yuan and reached 708.6 billion yuan by the end of May 1995. Anecdotal reports in the Hong Kong press also suggested that a growing number of cash-strapped state firms—particularly in China's northeast and in some hinterland cities—were unable to meet payrolls or were sending workers home on part-pay status.

These signs of mounting costs and risks for state enterprises spurred central leaders to fold a number of initiatives into a broad enterprise reform push for 1995:

- At a meeting in early November 1994 Chinese authorities announced the selection of 100 state firms and three state holding companies for conversion into either limited liability or shareholding enterprises—corporate categories that had been

China's Evolving Social Safety Net

Strengthening the urban social safety net—the benefits and services that help provide a minimum standard of living for workers hit by layoffs or who are retired—is one of the key facets of the new enterprise reform push. The regime hopes to replace enterprise-managed and -funded benefits with coverage that will remain in force for workers even if their employers are shut down. Pension reforms, for example, would establish "pooled" retirement systems funded by worker and enterprise contributions, unlike enterprise-managed systems which draw from operating budgets of individual firms and have virtually no funds set aside to pay future benefits:

- *Chinese press reports claim that as of mid-1995 over 87 million workers and 20 million retirees were participating in over 2,000 locally administered pension systems funded by salary deductions and matching employer contributions. Such pooled pension coverage is most prevalent in the state-owned sector where some 70 percent of workers are now covered.*

- *Unemployment systems are also expanding rapidly with central government encouragement. A Chinese press account in early 1995 claimed that the number of urban workers covered by unemployment insurance increased by 20 percent in 1994 to about 95 million by yearend.*

Social safety net concerns are also spurring renewed housing reform efforts. The State Council—China's cabinet—approved a new housing reform outline in mid-1994 to gradually commercialize the urban housing system and thereby enable workers to keep their apartments even if they lose their jobs or their enterprises are shut down. Workers, however, will have to pay far higher rents as enterprises cut housing subsidies—rents under the program are set to rise to 15 percent of average salaries by the turn of the century as compared to only about 1 percent now. To help workers purchase housing, the reform outline encourages cities to establish municipal reserve funds to underwrite affordable mortgages.

given legal status in the company law promulgated in July 1994—under a centrally supervised program. Provincial and lower-level authorities reportedly selected thousands of additional state-owned firms for limited experiments with the new company forms.

- Authorities broadened the state-sector reform push at a late November economic work conference by highlighting plans to undertake bankruptcy proceedings against selected deficit-ridden state enterprises along with other reform initiatives in 18 cities. By the end of 1994 authorities had drawn up a list of over 150 state-owned enterprise bankruptcy candidates under this program—47 of which were actually shut down in 1994, according to Chinese press accounts—and in early 1995 they had earmarked 14 billion yuan to help cover debts and ensure that displaced workers would receive assistance.[7]

- Chinese authorities used the terms of a new labor law that became effective in January 1995 to continue a long-term process of placing state enterprise workers under employment contracts that provide specific benefits for workers but also erode long-standing guarantees of lifetime employment. Meanwhile, the regime stepped up efforts to construct a social safety net of welfare and pension benefits to cushion the blow of bankruptcies and layoffs on the urban work force.

- Authorities folded other enterprise reform initiatives—including a three-year-old program to develop 56 large-scale state enterprise conglomerates—into the reform drive as well.

Chinese authorities have stated that the 1995 reform push is only a step in establishing a "modern enterprise system" under which state firms would function

[7] Bankruptcies among smaller state-owned firms are no longer rare. Chinese courts concluded 395 bankruptcy cases involving state-owned enterprises in 1994, an increase of 142 percent over 1993, according to a report delivered by the President of the Supreme People's Court in March 1995.

Budget Reforms on Track, but Deficits Rise

Despite the introduction of the new tax system beginning in 1994—which prompted China's Finance Minister to warn that targets for 1994 were only preliminary—Beijing in fact succeeded in keeping the official deficit excluding service costs on government borrowing slightly below the 1994 budget forecast. Nevertheless, the preliminary official government deficit of 63.8 billion yuan, plus 49.1 billion yuan in principal and interest payments on government borrowing, pushed overall government financing needs up by roughly 26 percent as compared with 1993:

- *Inflation contributed to a 9.4-percent increase in government expenditures in 1994—excluding debt service costs—as compared with the targeted growth of only 2 percent. Budgeted spending on national defense increased by 27 percent to more than 55.1 billion yuan in 1994, and it is projected in the 1995 budget to rise to 63.1 billion yuan.*
- *Inflation also increased prices on which taxes are levied, and the resulting 19-percent increase in tax receipts helped push overall revenues in 1994 up by 17.2 percent as compared with the 7.4-percent growth target.*

Beijing in 1994 also shifted to relying totally on sales of government bonds and other borrowing to finance the budget deficit as opposed to covering part of the deficit through overdrafts on the central bank. The elimination of overdrafts on the central bank—which virtually amounts to printing money—should help reduce inflation pressures and boost the independence of the bank, but it will add to the central government's debt financing costs. Indeed, although the target for the 1995 official deficit of 66.7 billion yuan is only about 5 percent above 1994's preliminary figure, principal and interest payments on foreign and domestic borrowing under the budget will jump by roughly 75 percent to more than 86 billion yuan as compared with 1994.

Despite taxation and budget reforms, the share of government revenue in total GDP continued to decline in 1994 to 11.8 percent of GDP as compared with 12.9 percent in 1993 and 13.2 percent in 1992. The failure of the regime—and particularly the central government—to capture a larger share of GDP in taxes limits Beijing's ability to direct national resources to infrastructure projects and to other development priorities. Central financial officials have recently pledged to redouble tax collection efforts—for example, by forcing enterprises and local governments to disclose off-budget incomes that often go untaxed—and to introduce new taxes in coming years to reverse the decline in the government's revenue position. Central finances should also get a boost if the regime succeeds in phasing out revenue rebates central leaders promised to provinces for up to three years when the new tax system was first approved in late 1993.

as legal corporations with clearly defined property rights and other characteristics of firms in market economies—a goal that Chinese authorities recently stated may not be reached until early in the next century. Chinese press reports have indicated that authorities are studying the results of recent bankruptcy cases in order to incorporate lessons in handling enterprise debts and liquidating assets into a new, comprehensive bankruptcy law that is currently being drafted.

Nevertheless, by mid-1995 even the limited experiments called for during the "year of enterprise reform" were encountering obstacles. Hong Kong press accounts and even some Chinese reports suggested that authorities were slowing bankruptcy experiments in favor of less disruptive enterprise mergers or management reforms. A Chinese press account in June indicated that only a handful of the 100 enterprises selected for conversion to limited-liability or joint-stock status had drafted specific plans, and only three of the firms had submitted plans for official approval.

Financial Sector Looks to Commercial Opportunities and Costs. China's banking sector continued to expand and diversify in 1994 and early 1995, but the costs to state banks of providing low-interest loans to support state enterprises became increasingly evident and hindered reform plans to put these banks on a purely commercial footing. Deposits held by the state banking system—which includes four major specialized banks, the remaining commercial business of the central bank, and several other state-owned financial institutions—increased by 16 percent in 1994 to 2,932 billion yuan.[8] Inflation-indexed interest subsidies on three-year and longer time accounts helped to boost total deposits by urban residents by 41 percent to 1,584 billion yuan, accounting for more than half of the total deposits in the state banking system by the end of 1994.

Total loans outstanding from the state banking system in 1994 increased by 514 billion yuan, up by 19.4 percent as compared with the end of 1993. Reflecting the regime's efforts to control credit expansion, this was the slowest growth rate since 1991 and down by 3 percentage points from 1993. Of this new lending, however, loans earmarked for fixed asset investment increased 38.6 percent. Indeed, loans from the state banking system for fixed asset investment more than doubled between June 1993 and June 1995 and now account for more than one-quarter of the system's loan portfolio.

Reflecting the adverse impact on the state banking system of lending to support state-owned enterprises, a senior Chinese central bank official reported in early 1995 that roughly 20 percent of outstanding loans from state banks—most issued to state enterprises—are overdue and at least 3 percent are considered unrecoverable. In early 1995 a major international rating service downgraded its rating of the four specialized state banks, in part because of uncertainties over government guarantees for such policy-directed loans. Profits at state banks were also squeezed by government orders to pay the inflation-indexed subsidies on top of interest rates for time deposits beginning in March 1994 without similar increases in loan interest rates. Of China's four major state-owned banks, only the foreign-trade-oriented Bank of China turned a profit in 1994, according to Chinese press reports.

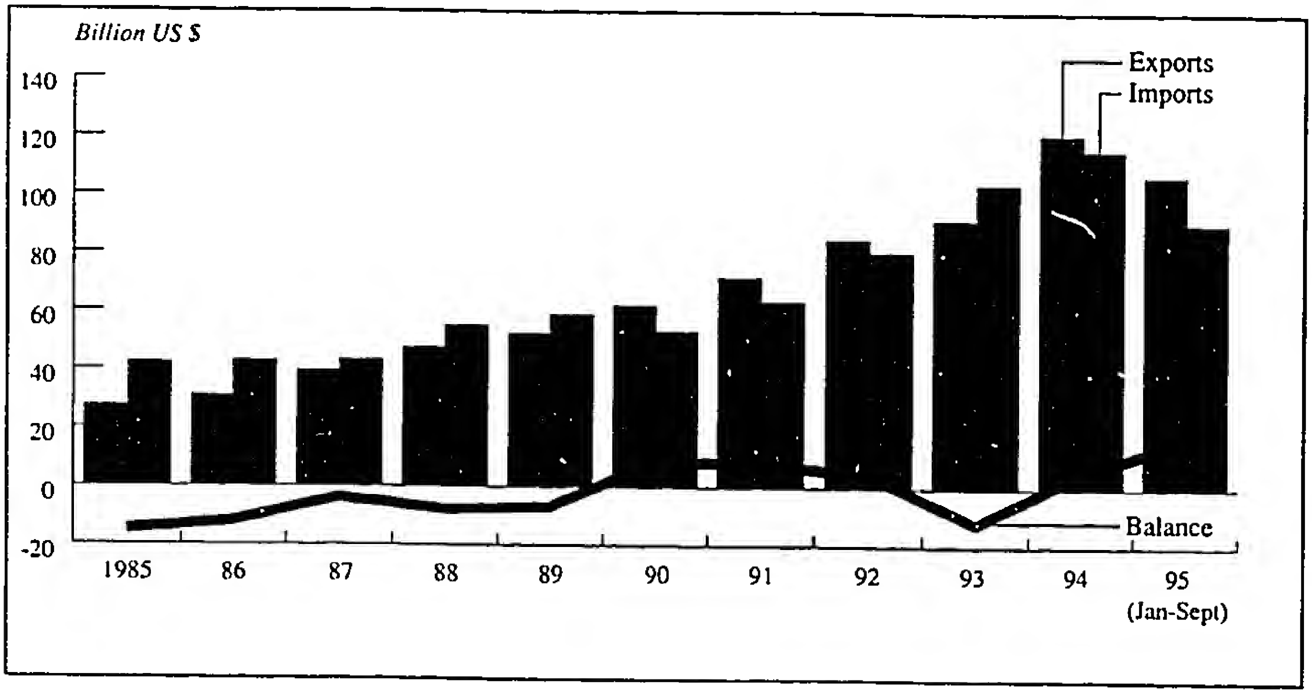
[8] The four major state-owned specialized banks are the Bank of China—which is China's leading bank in support of foreign trade and hard currency transactions—the Industrial Commercial Bank of China, the People's Construction Bank of China, and the Agricultural Bank of China.

To help eventually relieve state banks from the burden of issuing low-interest policy-directed loans, Beijing established three so-called policy banks in early 1994 to specialize in lending in support of state enterprises, agriculture, and foreign trade. The regime also touted provisions in the new commercial bank law authorizing bank officials to reject loan requests from local political authorities as measures that will enhance bank independence and profitability.

The process of converting major state banks into purely commercial ventures will be lengthy, however, and will entail costs for the banks as well. The commercial bank law, for example, requires state banks to divest themselves of trust and investment companies and other nonbank subsidiaries that some branches had used to lend money to real estate development and other ventures—lending that central authorities considered high risk and contrary to state development priorities but which paid handsome returns and helped offset losses from lending to support state enterprises. Under the central bank law, the state banks also still lack the authority to independently set interest rates on deposits and loans. State enterprise reforms may also take a further toll on bank balance sheets. To encourage mergers as a way of dealing with poor performers, for example, the regime announced in June 1995 that firms that annex failing state enterprises could receive a holiday of up to five years in repaying loans owed by the annexed enterprise.

Meanwhile, new players continue to enter the banking field to compete with the established state banking system. China now has 10 domestic commercial banks, one new foreign joint-venture bank, thousands of urban credit cooperatives that could be expanded into commercial banking operations under new reforms, and hundreds of trust and investment companies and other nonbank financial institutions. Deposits

Figure 4
China: Foreign Trade, 1985-95



Source: Official Chinese statistics.

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in these institutions reached 656.2 billion yuan at the end of June 1995 or 13.8 percent of total deposits in Chinese financial institutions, up from 10.5 percent only two years earlier.[9] Unlike most of the specialized state-owned banks, the commercial banks are largely unburdened with policy-directed loans and are reporting healthy balance sheets, according to Western press accounts.

[9] These figures do not include deposits of rural credit cooperatives—which operate under the supervision of the Agricultural Bank of China—as part of the emerging nonstate banking system.

Export Surge Lifts Foreign Trade Earnings. China's foreign trade performance emerged as an important bright spot in 1994 as government policies and foreign investors helped turn the near-record trade deficit of $12.2 billion in 1993 into a $5.3 billion trade surplus in 1994—a surplus that is continuing to grow in 1995. By granting firms refunds on value-added taxes paid on domestic goods used to produce export products, for example, the new tax system increased incentives

to export that helped boost the value of Chinese goods sold overseas by more than 30 percent in 1994. Indeed, almost all of China's major exports saw substantial sales increases on the world market in 1994. Only one of China's top 20 exports showed a decrease; sales of mineral fuels fell by less than 2 percent. Moreover, China at least doubled the growth rate of seven of its top 10 exports between 1993 and 1994.

Changes in China's foreign exchange regime probably also improved China's trade balance. Prior to January 1994, China maintained two exchange rates—the official rate and the "swap rate." On "swap markets," firms with central approval were allowed to buy and sell foreign exchange at a premium over the official rate. In January, China unified the two rates, effectively devaluing the official rate—which was roughly 5.8 yuan to the dollar—by about one-third to the swap rate level of 8.7 yuan to the dollar. Although press reports indicate that roughly 80 percent of all transactions took place at the lower swap rate at the time of unification, the depreciation of the currency for at least some transactions probably served to boost China's exports and slow the increase of imports. Moreover, the currency has been allowed to appreciate only slightly in 1994 and 1995. Continued high demand for the yuan—as Beijing seeks to limit credit in the domestic currency—suggests the yuan may be undervalued; such an undervaluation would have contributed to the rapid rise of exports and slower growth of imports.

Beijing is continuing efforts to increase the range and quality of its exports. In late 1994, for example, China published measures to boost exports of electromechanical products; the steps cited include increasing long-term credits and foreign exchange loans for producers and loans for technological innovation. China's new investment regulations—published in June 1995—are also designed in part to boost competitiveness in the long run by bringing in foreign investors willing to transfer technology and improve domestic production. The investment regulations "encourage" foreign investment that brings in new technology, including technology to increase the efficiency of factories, to improve the quality of production, or to produce goods for the international market.

China's export success in world markets has continued in 1995—sales to the world grew more than 34 percent in the first three quarters—but some of this rapid increase may be only temporary. In July 1995 the regime began refunding to exporters only a portion of the value-added taxes that had been paid on domestically produced inputs. Many exporters rushed to ship their products—or claimed to have shipped them—in the first half of the year when the higher refund rate was still in effect, accounting for some of the 44-percent growth in the value of exports in the first half of 1995 as compared with the same period in 1994. Indeed, exports by state-owned enterprises—the primary recipients of the refunds—grew faster than sales by foreign-invested enterprises by more than 20 percentage points earlier this year, suggesting the threat of a reduced refund may have been a primary driver behind this initial increase. In the third quarter of 1995, overall exports increased by 20 percent as compared with the same period in 1994, or less than half the growth scored in the first half of 1995 when the higher refund rate was in effect. Chinese officials have recently announced that the refund rate will be cut again in January 1996, however, giving exporters an incentive to complete their shipments before the end of the year.

China's slower import growth in 1994 reflects in part its mixed record on import liberalization. At the beginning of 1994, for example, foreign producers benefited from the elimination of import controls on more than 3,000 items, but at the same time China imposed quotas on such key products as autos, computers, and video cameras. Beijing's efforts to speed talks on its WTO accession probably played a part in its decision to eliminate quotas and licenses for 195 products in June 1994—including some goods that were not scheduled for liberalization under the Sino-US market access agreement until the end of 1994 and 1995.[10] In December, however, Beijing refused to

[10] The market access agreement signed by Beijing and Washington in October 1992 called for China to phase in commitments designed to lower Chinese barriers to trade in areas of particular interest to the United States. These included provisions designed to increase the transparency of China's trade regime, eliminate import substitution, and phase out licenses and quotas on certain products over a five-year period.

relax quotas slated for liberalization by the end of 1994 under the agreement because it claimed Washington had not lived up to its commitment under the agreement to "staunchly support" China's WTO accession. In June 1995 China finally fulfilled 1994's commitments.

China also restricted imports of some key commodities to protect domestic suppliers. Beijing temporarily restricted imports of steel and petroleum in 1994 in an effort to draw down growing domestic stocks of poorer quality products or inventories in areas without adequate transportation to move supplies to buyers. As a result, imports of iron and steel and mineral fuels fell by roughly 30 percent. Moreover, in 1994 China implemented its automotive industrial policy, which was intended to encourage domestic production. The policy places limits on new foreign investment in the production of complete vehicles and restricts imports of kits, causing China's purchases of vehicles to decline by almost 12 percent in 1994.

Continuation of some of these restrictive practices—and possible implementation of new industrial policies—will probably prevent Chinese import growth from matching that of exports this year. Nevertheless, continued attempts to ease its accession to the WTO will probably prevent Beijing from reversing its slow process of gradual liberalization. Import growth has rebounded moderately in 1995—in the first three quarters Chinese purchases were up 16.1 percent as compared with the same period in 1994.

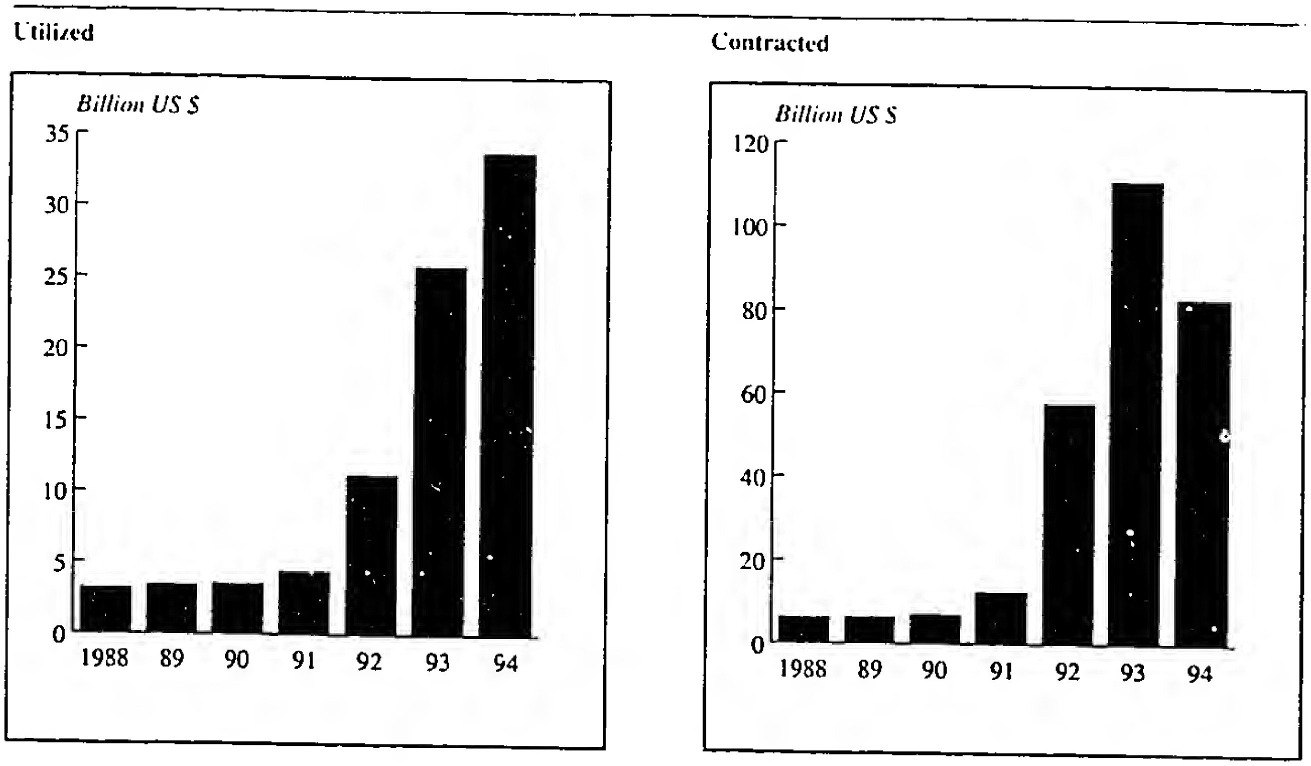
Foreign Investment Boosts Export Potential. Foreign-invested enterprises continued to be a key driver in China's trade as total realized foreign investment in China since 1980 topped $100 billion in 1994. These enterprises accounted for 37 percent of total trade in 1994, up from 34 percent in 1993. Exports from foreign-invested firms grew almost 37 percent while imports by these companies were up by more than one-quarter.

Beijing appears to have been successful in its efforts to increase the technological level of its exports, probably as a result of gradual increases in the technology level of products from foreign-invested enterprises. Sales of machinery and mechanical appliances, for example, grew by more than one-third and exports of electrical machinery and equipment were up by more than 45 percent. Sales in these two sectors alone accounted for more than 16 percent of China's exports to the world, up from 13.6 percent in 1992.

Beijing is seeking to ensure that foreign investment in medium- and high-technology sectors continues. Emboldened by another record high in foreign investment in 1994—paid-in direct foreign investment reached $33.77 billion, up by 31 percent over 1993 and more than triple 1992's level—Beijing took steps to attract foreign investment in high-priority sectors. China is particularly seeking to shift investors in the coastal provinces into higher technology, longer term investment and to move low-cost, labor-intensive production inland. In October 1994, for example, the State Council established the Central Leading Group for Foreign Investment headed by Vice Premier Li Lanqing—the former head of China's Trade Ministry and the apparent architect of Beijing's investment strategy—according to press reports. Beijing codified its foreign investment policy in regulations published in late June 1995.

As Beijing seeks to direct investment to priority sectors, it also appears to be attempting to level the playing field between state enterprises and foreign-invested firms by revamping regulations that have given foreign-invested enterprises preferential treatment. As part of Beijing's effort to treat all enterprises equally, it granted Chinese companies as well as foreign-invested enterprises established beginning in January 1994 the right to a refund for value-added taxes on domestic inputs used in products that are exported—effectively providing these firms an incentive to export. Foreign-invested firms established under the old system, however, will not be granted the right to this refund for domestic inputs for five years because they have incentives—such as tax exemptions for some imported machinery—not granted to domestic enterprises. Instead, China has promised to cover the difference between their new tax burden and that which applied under the old system.

Figure 5
China: Direct Foreign Investment, 1988-94



Source: Official Chinese statistics.

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Chinese officials are also continuing their efforts to crack down on investors who overvalue the equipment they contribute as their share of a joint venture. Beijing has begun to confiscate overvalued equipment brought in as part of joint ventures and has published some regulations on how equipment should be valued as well as the length of time a foreign investor has to pay in committed funds. An official from the State Administration of Taxation noted that 40 percent of foreign-invested enterprises were found to be evading taxes.

Press reports suggest Beijing's policies are having some effect. The average dollar value of paid-in investment for an individual project, for example, grew from $1.3 million in 1993 to $1.7 million in 1994, indicating Beijing has been somewhat successful in encouraging larger, longer term projects. Moreover, the central government may have succeeded in shifting contracted investment into its priority industries. The Chinese press reports that the number of large foreign-funded projects in energy and transportation rose, and the proportion of capital going to industrial investments increased. Foreign investment in communications and telecommunications jumped by more than 36 percent in 1994, for example, according to the Chinese press. While maintaining the high levels achieved during the past few years, however, the value of paid-in investment in the first half of 1995 increased by only 11 percent over the same period in

1994, the slowest growth rate since 1990. The value of pledged foreign investment actually declined in 1994 for the first time in eight years, although the falloff may reflect more realistic assessments of the value of pledged investment after figures had become bloated in recent years with deals that were unlikely to ever be completed.

The share of paid-in direct foreign investment in China accounted for by Hong Kong and Macau fell to 60 percent in 1994, down from 70 percent in 1992, while the share of investment from Taiwan increased only marginally to 10 percent in 1994 as compared with 9.5 percent in 1992. The performance of these investment leaders probably in part reflects the effects that Beijing's targeting efforts are having; firms from these regions often invest in sectors that Beijing is discouraging, such as export processing and real estate. The United States and Japan ranked just behind these economies as the third- and fourth-largest investors, respectively; the United States accounted for over 7 percent of paid-in direct foreign investment in 1994. Other newer investors are also increasing their roles in China, although their shares remain small. Both South Korea and Singapore, for example, have roughly doubled their share of investment in China since 1992, but their combined share accounted for less than 6 percent of all direct foreign investment in 1994.

Challenges Ahead in Regulating Growth, Continuing Reforms

Despite the regime's success over the past two years in bringing the country to the verge of an economic "soft landing," central leaders continue to face difficult tradeoffs between fighting inflation and limiting the costs of the slowdown in growth rates. Indeed, precisely because the inflation danger appears to be receding, central leaders are likely to face increasing demands to ease credit controls and other retrenchment policies—demands that will intensify if labor disturbances spread as enterprises fail to make payrolls and as job opportunities outside the state sector shrink.

Nevertheless, latent inflationary pressures remain in the economy. Although the growth in the broad money supply (M2) has eased since the year-on-year growth peak of 37 percent at the end of the third quarter in 1994, M2 was still up by over 30 percent at the end of the third quarter of 1995 as compared with the same period in 1994. Furthermore, at least some of Beijing's recent success in controlling further price hikes is due to price controls and subsidies—administrative tools that tend to suppress inflation rather than eliminate pressures for further price increases. Central leaders thus face the risk that, if they give in to lobbying by local officials and other authorities to relax controls and to even stimulate growth, they could again quickly face renewed inflation.

At a time when Deng Xiaoping—the senior leader most closely identified with economic reforms for the past 15 years—has virtually retired from policymaking, central leaders must also continue to balance the costs and benefits of tough reform steps. Chinese media reports suggest that further economic legislation—including a revised bankruptcy law and a new securities law—are in the works and may be approved in 1996. Hong Kong and Chinese press accounts also suggest that central authorities are considering a plan that would concentrate state support on a limited number of key larger state-owned firms—some reports say a thousand state firms would fall into this category—while tens of thousands of smaller state firms would be left to face marketplace forces. Other pending reform steps that Beijing may take over the next year include the formation of an open market committee within the central bank to begin trading in government bonds—a mechanism that would help the regime indirectly control the money supply and could also speed liberalization of financial markets in general. These steps would strengthen economic institutions and could help the regime broaden the role of market forces in the economy.

While they may be considering such steps, central leaders currently appear hesitant to push ahead with potentially disruptive reforms despite the costs of delay. The leadership's apparent decision, for example, to focus on spadework—such as improvements in unemployment insurance coverage before undertaking wider state-sector bankruptcies—adds to the burden of state-sector losses on the state banking system. The

central leadership's preference to delay risky state-sector reform measures suggests that substantive changes to the state sector will remain a reform goal for years to come.

Central leaders also face obstacles in completing other reforms initiated during the past two years. Although tax reforms have begun to erect a new framework for collecting central revenues, for example, central authorities face tough opposition from localities as they attempt to squeeze more revenue from the economy. The ability of central leaders to make progress on these reforms in the near term may be further hampered by the leadership's concerns over domestic stability as they approach the end of the Deng Xiaoping era and grapple with the declining influence of the Communist Party.

Appendix A

A Chronology of Economic and Political Developments, January 1994–September 1995

January 1994	Beijing unifies the official and swap center exchange rates, thereby devaluing Chinese currency for some transactions.
	Chinese authorities begin implementing a new taxation system that earmarks specific taxes for central and local coffers and increases the reliance on value-added taxes for revenues.
March 1994	Leadership speeches at the March 10-22 National People's Congress session emphasize stability.
	Beijing establishes the China Development Bank and the Agricultural Development Bank to consolidate domestic policy-directed lending.
April 1994	Beijing establishes the China Export-Import Bank to assist in financing foreign trade.
	Beijing establishes the China Foreign Exchange Center in Shanghai as the lead institution in an interbank network for foreign exchange transactions.
May 1994	The National People's Congress Standing Committee approves a draft law on compensation by the state and three other draft laws.
June 1994	The regime boosts state-mandated grain prices by roughly 40 percent.
	Beijing releases the outline of a new industrial policy strategy and an accompanying industrial policy document for the automobile industry.
July 1994	The Standing Committee of the National People's Congress approves a labor law that specifies that all employees must have labor contracts negotiated through collective bargaining and bolsters arbitration mechanisms for labor disputes.
August 1994	Beijing publishes a State Council decision on urban housing reform.
September 1994	The Fourth Plenum of the 14th Central Committee held in Beijing from September 25 to 28 concentrates on party-building issues. The Plenum appoints Shanghai party secretary Wu Bangguo and Shandong Provincial party secretary Jiang Chunyun to the Politburo Secretariat, and both men surrender their local party positions.

	Premier Li Peng outlines anti-inflation price control steps—the 10 points—in a September 6 telephone conference.
October 1994	The China Securities Regulatory Commission after review grants operating licenses to 11 commodities futures exchanges.
	The National People's Congress Standing Committee approves the Urban Real Estate Management Law that will go into effect on January 1, 1995.
November 1994	Central authorities convene a National Economic Work Conference in Beijing from November 28 to December 1.
January 1995	The People's Bank of China raises the discount rate effective January 1; this move affects loan interest rates, but enterprise and personal deposit rates are unchanged.
February 1995	China's population officially surpasses 1.2 billion.
March 1995	The National People's Congress session from March 5 to 18 appoints Wu Bangguo and Jiang Chunyun as Vice Premiers. The session also approves the central bank law.
April 1995	Beijing Municipal party secretary Chen Xitong is removed from office in a move linked to the corruption crackdown.
May 1995	The National People's Congress Standing Committee passes the commercial bank law that will become effective in July 1995.
	China adopts a 40-hour work week, replacing a 44-hour work schedule under which many urban residents worked every other Saturday.
June 1995	Dai Xianglong is named to replace Vice Premier Zhu Rongji as Governor of the People's Bank of China.
	The State Planning Commission, the State Economic and Trade Commission, and the Ministry of Foreign Trade and Economic Cooperation jointly issue provisional regulations on guiding foreign investment.
September 1995	The Fifth Plenum of the 14th Central Committee held in Beijing from September 25 to 28 approves the Committee's proposal for formulating the Ninth Five-Year Plan and 15-year development targets. The Plenum also removes former Beijing Municipal party secretary Chen Xitong—under investigation for corruption—from the Politburo.

Appendix B

China's Bilateral Trading Relationships in 1994

In 1994, China's success in attracting foreign direct investment began to pay off as more projects came on line that contributed to rapid increases in sales of low-end medium-technology goods in most of its major export markets. China remained competitive in labor-intensive products—including toys, footwear, and textiles—although the growth of sales of these products is slowing in markets such as the EU and the United States. China's trading partners saw sales of key exports grow only slowly or decline as a result of Beijing's restrictions on imports—which are intended to draw down domestic inventories or protect domestic industries—in such sectors as automobiles and steel. Slower growth in Chinese demand for some industrial products may also have reflected the slower pace of domestic investment growth.

Slowly Shifting Structure of Sino-US Trade
China's trade surplus with the *United States* grew 30 percent in 1994—outpacing 1993's 25-percent growth—to $29.5 billion, according to US statistics.[11] Chinese exports to the United States did not grow as quickly as Chinese sales to the world; nevertheless, Chinese exporters did increase sales almost 23 percent last year to $38.8 billion. China's imports from the United States grew only 6 percent to $9.3 billion—about half the rate of China's imports from the world—as the United States faced declining sales in key export sectors.

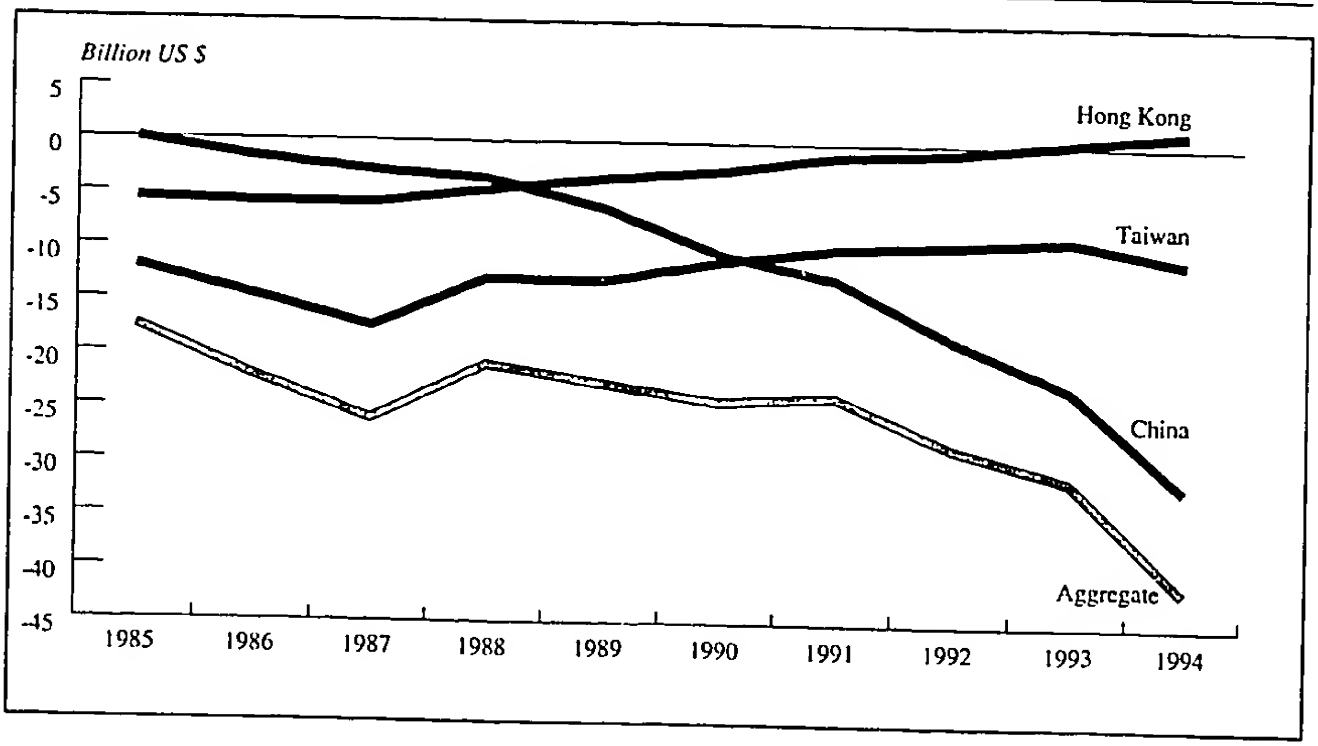
China's sales to the United States continue to be dominated by low-cost, labor-intensive products; indeed, exports of apparel, footwear, and toys alone accounted for almost 40 percent of total Chinese exports to the United States. Moreover, the United States continues to be China's primary market for such products, absorbing at least half of its exports to the world in product categories such as plastics, leather goods, footwear, headgear, furniture, and toys, and China increased its share of the US market in most of these sectors last year. China now accounts for 48 percent of all US imports of leather goods—up from 35 percent just two years ago—and 46 percent of US toy and game imports. Chinese apparel sales to the United States, however, fell 4 percent in 1994; the decrease is probably due in part to increased Chinese efforts to abide by US textile quotas.

China saw its fastest growth in sales to the United States in medium-technology goods, suggesting foreign investment in these sectors is gradually coming on line and increasing China's competitiveness. Indeed, electrical machinery and equipment ranked as the top Chinese export to the United States for the first time last year, replacing footwear. Sales to the United States of mechanical appliances, electrical machinery, and photographic and measuring equipment all increased by about half last year, more than double the growth of US imports from the world in each of these sectors.

While sales of electrical equipment, transportation goods, and scientific and measuring instruments remain among the top US exports to China, their sales grew only slowly or declined, and in some sectors the United States lost ground in 1994 to traditional foreign rivals. US sales of aircraft, for example, fell more than 14 percent in 1994, and the United States lost nearly half of its share of China's market. It is too early to tell whether this represents any long-term decline in the US share of this market because the purchases and deliveries are made in large increments—leading to the possibility of large swings in exports from year to year. France, however, did see its aircraft sales to China more than triple in 1994. US producers also felt the effects that year of China's efforts to protect domestic automobile producers as part of the

[11] Chinese statistics recorded a surplus with the United States totaling almost $7.5 billion in 1994. Most of the differences between the two data sets are caused by valuation variations and different approaches to accounting for transshipments through Hong Kong and other countries. As these factors also affect China's trade with other countries, all statistics are derived from data provided by China's trading partners rather than from Chinese data, unless otherwise noted.

Figure 6
US Trade Balance With China, Hong Kong, and Taiwan, 1985-94



Source: US Department of Commerce.

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new industrial policy for automobiles; China's imports of vehicles from the world were down more than 11 percent, and US sales of autos fell 60 percent.

The most volatile US exports to China continue to be in the agricultural sector—which is particularly sensitive to domestic supply and international prices; as a result, gains or losses in this sector for one year do not necessarily reflect long-run trends. A mediocre Chinese harvest—and shortages in other producing countries—helped give the United States its largest growth in sales to China in cotton, which became the fifth-largest US export to China. The US share of China's cotton imports jumped from 13 percent in 1992 to roughly one-quarter in 1994; US cotton sales to the world grew more than 50 percent. Other agriculture-related goods also made big gains. US exports of animal and vegetable fats and oils grew more than 36-fold to become the eleventh-largest US export to China; in 1993, oils were not in the top 45 export categories. Fertilizer sales more than tripled, boosting the US share of China's import market from 22 to 53 percent.

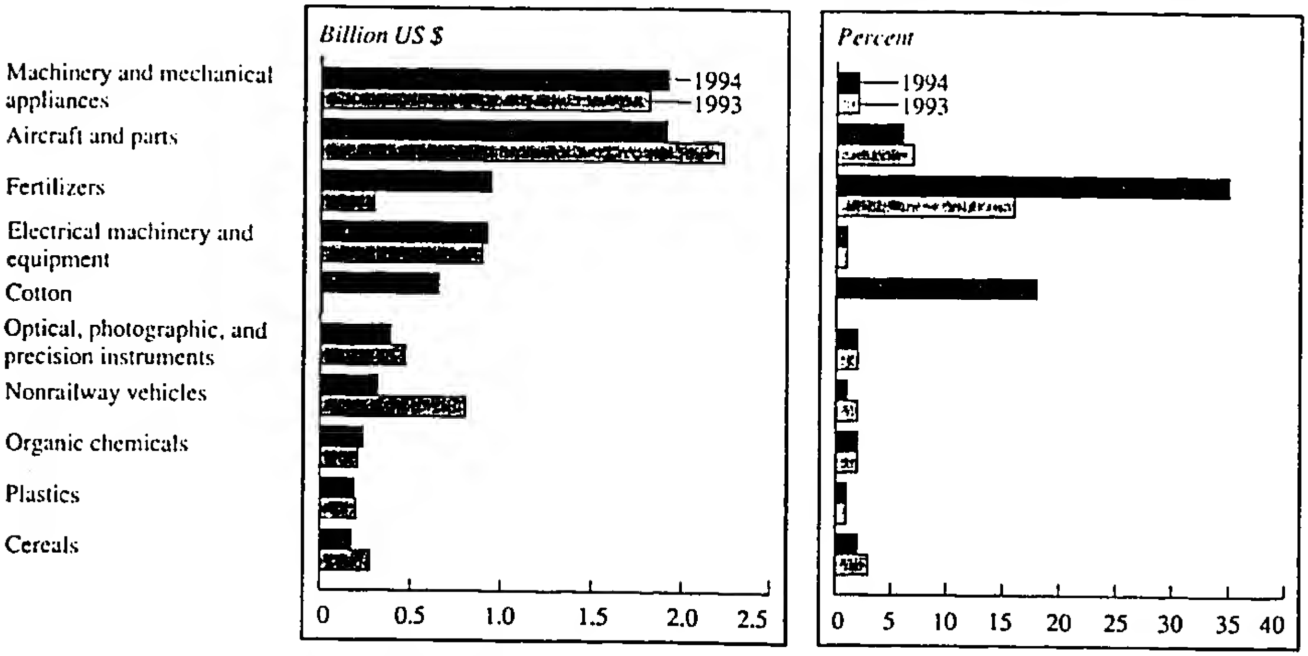
Trends for the first eight months of 1995 are very similar to 1994's results. Chinese exports of technology goods continued to grow rapidly, while apparel sales

Figure 7
The Structure of Sino-US Trade[a]

Note scale change

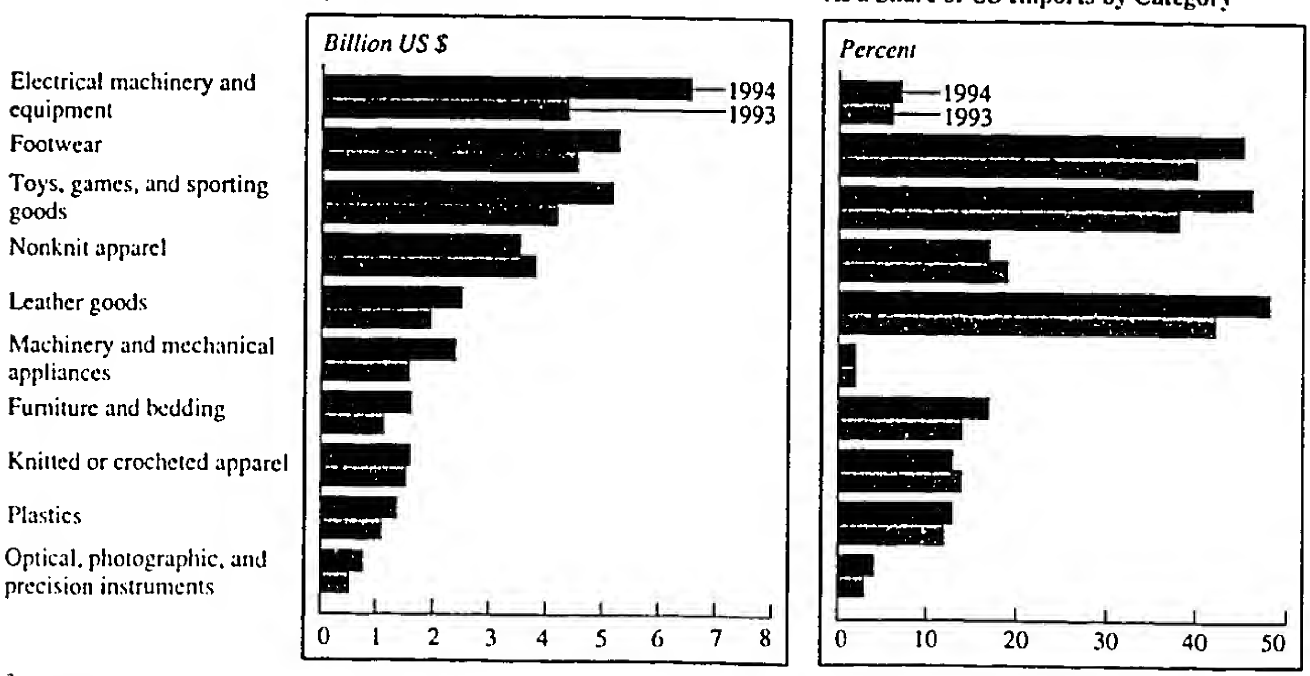
China: Top 10 Imports From the United States

By Value | **As a Share of US Exports by Category**



China: Top 10 Exports to the United States

By Value | **As a Share of US Imports by Category**



[a]Products are ranked on 1994 data. Data in these charts are based on HSN two-digit-level product classification and are not comparable to the SITC series used in previous years.

Source: US Department of Commerce.

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were stagnant; total Chinese sales to the United States rose 21 percent. Chinese imports of grain and oils again increased dramatically, but purchases of US aircraft and mechanical appliances and machinery decreased. Overall Chinese purchases of US products grew nearly 13 percent; if current trends continue, the US deficit will reach a new record level of more than $36 billion for 1995.

Trade With Japan Gaining Ground

China's trade with *Japan* is increasing in importance—total trade was up 22 percent and trailed Sino-US trade by only $1.6 billion in 1994. This growth, however, was driven primarily by a rapid increase in Chinese sales to Japan; Chinese exports grew 34 percent, while imports from Japan were up only 8 percent. This uneven growth gave China its largest trade surplus with Japan in more than 10 years—it nearly tripled to $8.9 billion. In late August 1995, Tokyo announced a freeze in nonhumanitarian grant aid, effectively cutting aid by more than $70 million from 1994's level. Nevertheless, Tokyo has left in place its concessional loan program—worth more than $6 billion between 1996 and 1999—allowing the bulk of the aid relationship to continue.

Chinese sales to Japan in 1994 were strong across the board. Some of the most notable increases were in agricultural goods and foodstuffs. Chinese exports of cereals tripled, and preparations of meat and fish grew by more than 80 percent. China also saw large gains in sales of more sophisticated goods, probably produced by newly operating foreign-invested companies. For example, sales to Japan of electrical machinery and equipment—China's fourth-largest export to Japan—grew by more than one-half in 1994. Japanese camera manufacturers are also increasing their operations in China, producing primarily for export to Japan, the EU, and the United States, according to Japanese press.

Tokyo, however, views China's success in some sectors as unwelcome because of concerns from domestic industries. Chinese sales of knitted or crocheted apparel, for example, were up nearly 40 percent, and Japan now accounts for 44 percent of all Chinese sales in this category; in contrast, the US share fell 5 points to 25 percent in 1994. This suggests that China has seen some success in limited areas at finding new export markets to help reduce its reliance on US sales. Under pressure from Japanese textile producers, Tokyo has launched an investigation that could result in quotas being placed on Chinese textile exports.

In 1994 the steady stream of business delegations traveling between Tokyo and Beijing continued. Representatives of Japan's auto industry made several trips to China as part of an overall strategy to increase their role in China's domestic auto market. Beijing's new auto industrial policy is not only spurring investors to compete for limited opportunities to establish plants in China but is also sharply limiting sales of automobiles and automobile parts. Japanese producers were no exception; their sales of vehicles and parts to China in 1994 were down 22 percent.

Producers of other key Japanese exports were also hurt by Chinese policies to limit domestic investment and draw down inventories. Limits on Chinese steel imports, for example, led to a 30-percent decline in purchases of Japanese iron and steel; imports of articles of iron and steel were up only 6 percent. Nevertheless, Chinese demand for higher technology Japanese goods remains high. Purchases of Japanese organic chemicals increased 40 percent—partly at the expense of the United States, whose market share fell slightly in 1994—and imports of electrical machinery and equipment grew 30 percent, just keeping pace with global Chinese imports of these products.

Europe Less Successful in the China Market

When the EU adopted a unified quotas system in February 1993, it decided to maintain quotas on seven categories of Chinese imports, including footwear, kitchenware, radios, and toys. As a result, China's sales of footwear and toys to most of its European trading partners grew only slowly in 1994. Apparel sales—covered by a separate agreement—also were stagnant in many markets. Officials from the EU and from member countries continued trade promotion efforts in China in 1994; nevertheless, Germany, the

United Kingdom, and Italy all saw a sharp slowdown from 1993's rapid growth in sales to China.

Among China's top European trading partners, *France* saw the biggest gains in China in 1994 as its sales increased 35 percent. The increase was driven primarily by French aircraft sales, which more than tripled and accounted for over one-third of all French sales to China. Chinese producers, however, did not match French success in export growth, and China's surplus declined by 13 percent to $1.9 billion in 1994. China's exports were up only 10 percent, hindered by falling sales in toys and stagnant sales in footwear. Chinese exporters of higher technology goods, however, were able to boost sales to France. Exports of consumer electronics were up 17 percent, and sales of scientific and measuring instruments grew 42 percent.

Despite continued official government-sponsored efforts to promote trade with China, *Germany* fared less well in 1994, as China's trade surplus grew by one-quarter. Germany's sales grew only 9 percent, much slower than 1993's 57-percent increase. German producers were hurt by China's automobile industrial policy as automobile sales fell by half. Sales of industrial machinery and tools were stagnant. Chinese exporters, on the other hand, increased sales to Germany by 14 percent. As in its exports to other countries, China's biggest gains were not in traditional low-cost, labor-intensive goods. Footwear sales declined, while clothing and toy exports grew 6 percent and 1 percent, respectively. Sales of office equipment, however, jumped 83 percent, and telecommunications equipment sales grew 22 percent.

Italy's exports to China remain concentrated in machinery and mechanical appliances; sales in this category account for more than two-thirds of all Italian exports to China. The 6-percent decline in Italian exports in this category in 1994—coupled with a 75-percent decline in sales of iron and steel—led to a fall in overall exports of almost 9 percent. Chinese exports to Italy, on the other hand, followed the same pattern as in other European countries. Sales of apparel and toys grew only slowly or declined, while exports of machinery and mechanical appliances increased by more than half. Electrical machinery and equipment sales grew more than 28 percent and became China's top export to Italy. These sales boosted Chinese exports to Italy by one-fifth last year, pushing China's 1994 surplus with Italy to nearly five times the level in 1993.

Sales by the *United Kingdom* to China were up 15 percent in 1994—much slower than 1993's growth of more than 65 percent—in part as a result of nearly stagnant growth in Chinese imports of British machinery, which account for nearly 70 percent of all Chinese purchases from the United Kingdom. Exports in special categories—which include coins and gold—increased more than 150 percent, accounting for much of Britain's overall increase. Chinese exports—up 16 percent—again followed a pattern similar to that with its other EU trading partners. Chinese machinery sales grew by nearly one-half, while clothing sales increased only 4 percent and exports of toys and games fell by more than one-quarter. China's trade surplus with the United Kingdom grew 16 percent to just over $1.2 billion.

Other Key Trading Partners

Canadian trade promotion efforts—such as Prime Minister Chretien's visit to China with provincial leaders and 400 business representatives—helped boost Chinese imports from Canada 22 percent in 1994 after 1993's 26-percent decline. Chinese sales to Canada, however, reached $2.8 billion, growing 18 percent for the second straight year and widening China's trade surplus with Canada by roughly 18 percent to $1.2 billion. Chinese purchases of wheat—which accounted for one-quarter of all Chinese imports from Canada—rebounded strongly. Purchases of Canadian wheat increased 21 percent, allowing Canada to retain its position as China's top wheat supplier. China also more than doubled its imports of fertilizers—China's third-largest import from Canada. Chinese producers saw their sales to Canada fall in areas of traditional export strength; Chinese apparel exports were down more than 10 percent in 1994. These losses, however, were more than made up for

by booming sales of electrical machinery, which grew more than 40 percent and displaced nonknitted apparel as the top Chinese export to Canada.

China's trade with *South Korea* continued to grow rapidly in 1994, but the direction of trade nearly reversed as China's deficit shrank roughly 40 percent to less than $780 million. China's imports grew 20 percent in 1994, less than one-quarter of the rate they grew in 1993. Chinese restrictions on imports of iron and steel and vehicles limited the growth of imports from South Korea; Chinese imports from South Korea of these goods fell 30 and 70 percent, respectively. Nevertheless, South Korea saw rapid growth in sales of goods that are probably used in Korean-invested factories in China; raw hides and skins, for example, were up by over three-quarters and captured more than one-fourth of China's import market. Exports of electrical and mechanical machinery were up more than 30 and 60 percent, respectively. At the same time, China's sales to South Korea were up almost 40 percent, rebounding from 1993's modest 5-percent increase. This increase was driven largely by skyrocketing sales of clothing and footwear—sectors where South Korean firms have lost competitiveness as a result of rapid wage increases. Exports of these goods doubled in 1994, probably partly compensating for slower apparel sales to the United States and Europe. China's sales of electrical machinery and equipment—largely household and light industrial goods—also increased by more than 60 percent.

After 1993's modest growth in sales to the mainland, *Hong Kong* producers saw their sales to China decline in 1994 by almost 4 percent. Exports of technology goods, rather than labor-intensive products, appear to be taking the largest losses. Hong Kong sales of telecommunications equipment and specialized machinery, for example, both fell by roughly 12 percent. Chinese purchases of apparel, on the other hand, increased 25 percent.

China's trade with *Taiwan* in 1994 was more than double that of 1991, according to estimates made by Taiwan's Board of Foreign Trade (BOFT). China's imports from Taiwan grew 15 percent to nearly $15 billion as realized official investment from Taiwan reached a record $3.4 billion for the year, according to BOFT statistics. Hong Kong statistics—which are recorded in a slightly different way than BOFT data—note that Taiwan transshipments to China of both electrical machinery and textile yarn, fabrics, and apparel were up by nearly one-third, and sales of plastic in primary forms to the mainland increased by almost one-half. Chinese sales to Taiwan made even larger gains in 1994—they were up 83 percent—although the value of exports to the island was just under $2 billion. The rapid increase was probably spurred by Taipei's gradual increase of allowable imports of raw materials and semiprocessed goods from the mainland since 1993.

Chinese trade with *Russia* fell dramatically in 1994, in spite of efforts by both sides that were intended to maintain or increase it. A Chinese economist told the Chinese press that attempts to shift trade away from barter fell afoul of poor transportation systems and a shortage of hard currency on both sides of the border. Partly as a result of these problems, Chinese exports declined by 41 percent, according to Chinese statistics. For example, exports of textiles—China's top export to Russia—fell by more than 40 percent; sales of prepared foodstuffs—the second-largest export—fell by nearly 60 percent. China's imports from Russia fell by almost 30 percent, as purchases of base metals and transportation equipment fell by 18 and 77 percent, respectively.

Appendix C

Implications of China's Strong Foreign Debt Position

China's foreign debt grew an average of 24 percent annually since 1980 to $92 billion at the end of 1994, according to press reports, making China the world's fifth-largest debtor nation. China, however, is probably able to repay its external obligations—an issue many in Beijing regard as a point of national honor and a necessity for China to continue to attract financing for its economic modernization effort—because of its steady export growth and buoyant foreign investment. Efforts to reform China's economy will probably raise the country's foreign debt through the end of the century, but Beijing's control over borrowing and continued strong export growth are likely to put China in a good position to avoid a payments crisis.

Central Controls Keep Debt in Check

Tight control over capital flows has helped China maintain a strong debt position, despite rapid growth in foreign obligations. According to World Bank and International Monetary Fund data, China's external debt rose from $4.5 billion in 1980 to $92 billion in 1994. Nonetheless, press reports indicate China's 1994 debt-service ratio was 8 percent, well below the internationally recognized warning level of 20 percent. China's international capital flows also indicate it is well positioned to meet its debt requirements. Its capital account has been in surplus nine of the last 10 years largely because of heavy direct foreign investment inflows; the current account has also been healthy—with surpluses five of the last six years—as exports averaged 18-percent annual growth from 1990 to 1994. Hard currency holdings have risen sharply since January 1994, when Beijing began requiring exporters to sell all hard currency earnings to the People's Bank of China. Consequently, foreign exchange reserves rose from $21 billion in January 1994 to $63 billion in June 1995, according to press reports.

China's emphasis on paying its foreign obligations and its desire to control external contacts led Beijing to construct a highly centralized debt management system in the early 1980s. All Chinese organizations wishing to borrow on international markets must get

Data Problems in Balance-of-Payments Analysis

China's balance-of-payments (BOP) data series, like many of the country's major economic indicators, provide a measure of general trends in the country's economy, but various reporting indicates that some statistical series are flawed. Consequently, the International Monetary Fund has been working with Beijing for several years to improve China's BOP numbers. According to IMF reporting, Chinese BOP statistics have suffered because of major omissions in the capital account, such as direct investment abroad by Chinese enterprises, and nonbank holdings of foreign assets. Many items in the current account—such as freight on imports, remitted profits, and income from royalties—were not measured according to IMF standards.

Statistical errors occur in China's economic reporting largely because the country's data collection effort is relatively new and developing. During the 10 years preceding the death of Mao Zedong in 1976, China lost a generation of scholars to the internecine political battles of the Cultural Revolution. As a result, China does not have enough accountants and statisticians to monitor its large and diverse economy. In addition, China's nascent data gathering system is not developed enough to monitor closely for deliberate errors in reporting. Chinese officials are aware that some manipulation of economic statistics occurs, and they are concerned about the quality and competence of the people collecting the numbers.

Chinese foreign debt numbers also vary from source to source. According to the World Bank—which draws its data from China State Administration for Exchange Control—China's total debt in 1993 was $83.8 billion, however, OECD figures—which are based on Bank of International Settlements reports—puts the debt at $89 billion. In this report, unless otherwise indicated, we have used World Bank data.

permission from the People's Bank of China, which in turn is monitored by the State Council, according to press reports. Joint ventures are not required to obtain government approval but must report their debt. The State Planning Commission drafts the annual borrowing plan, which covers all medium- and long-term external borrowing, after reviewing submissions from central and provincial government departments and Chinese institutions authorized to borrow abroad. The plan sets debt ceilings for all borrowers and often identifies the project to be financed by a loan. Typically, Beijing only approves projects that are consistent with its industrial policy objectives, such as promoting infrastructure development.

To protect the country's debt repayment capacity and to guard domestic equities, China keeps controls on trade, which also affect capital flows. China boosts exports by granting some firms guaranteed access to raw materials and preferential import tariffs. Beijing also restricts imports by promoting consumption of domestically produced goods through import restrictions or domestic subsidies.

Beijing Managing Conflicting Goals

Beijing's efforts to modernize its economy, nevertheless, conflict with its intention to control debt and manage international financial transactions. *The central government's plan to build an infrastructure* equipped to service a sophisticated economy will add to China's foreign debt burden. China has little alternative but to pour money into these projects because its infrastructure needs are immense and vital to maintaining strong economic growth:

- China plans to spend $56 billion on the telecommunications sector over the next five years to increase its 50 million lines of switching capacity to over 100 million lines by the year 2000, double the number of phones to 65 million, and install 22 interprovincial fiber-optic trunk cables, among other projects.

- Beijing estimates the number of cars in China will increase fivefold by 2010, which will require a $38 billion investment in roads; the railways, already overburdened, will need $52 billion to expand rail lines.

According to numerous Chinese officials, these infrastructure projects—including power, telecommunication, and transportation deals—will cost China $230 billion by the year 2000. Beijing hopes domestic capital markets will finance 80 percent of the projects, indicating China could turn to foreign sources for as much as $46 billion of its financing needs.

As part of *China's drive to join the World Trade Organization*, contracting parties are asking Beijing to liberalize its foreign economic relations in ways that could affect the country's capital flows:

- According to press reports, numerous developed countries have asked Beijing to phase out trade-distorting subsidies and to eliminate nontariff trade barriers. Although these reforms may make trade more transparent, they might shrink China's trade surpluses and thus slow growth in foreign exchange.

- In addition to systematic trade controls, China is being asked to weaken instruments it uses tactically to safeguard its BOP position. Contracting parties, for example, are requesting Beijing not to use protection of infant industries as a justification to implement policies to guard China's balance of international finances. They are also asking that, when China takes actions to guard its BOP account, it promptly and publicly announce its tactics and defend their use.

- WTO members are pressing Beijing to remove restrictions on access to hard currency and eliminate guidelines specifying the priority uses of foreign exchange. In addition, China is being asked to bring its foreign exchange regime into conformity with International Monetary Fund Article VIII, under which members must maintain complete currency convertibility on current account transactions.

Further economic decentralization—a byproduct of liberalization—could also cause foreign debt to grow quickly by putting more Chinese entrepreneurs in a position to take on external financial obligations. Last year, Vice Premier Zhu Rongji—one of China's top

economic policy makers—complained that the central government does not have sufficient control over borrowing by local entities and, according to press reports, said that, beginning this year, foreign debts will be included in state plans—almost certainly an effort to control borrowing at the local level.

Beijing To Move Cautiously

Central leaders may well err on the side of caution as China modernizes its economy. According to press reports, People's Bank of China Vice Governor Zhu Xiaohua said last year that China planned not to take on more than $5 billion in new debt in 1995, and other officials have stated Beijing will limit debt accumulation to $10 billion per year through the end of the century. In an effort to control local borrowing, Beijing announced in 1994 that provinces would be prohibited from acquiring international credit ratings.

China's strategy to slowly relax controls over capital flows will probably help the country avoid a foreign debt crisis during the next several years. Beijing's cautious approach to easing controls on capital flows will probably help keep its BOP status from deteriorating sharply. A study by an independent private research firm indicates that double-digit export growth will probably keep China's debt-service ratio safely below 20 percent. Strong exports will also bolster the current account, pushing reserves past $100 billion by 1998. Although foreign debt will rise, the capital account will be balanced by healthy inflows of foreign investment.